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No. 31

In the Supreme Court of the United States

OCTOBER TERM, 1929

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SANFORD & BROOKS COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF

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v.

SANFORD & BROOKS COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF

PETITION

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fourth Circuit, entered in the above case on October 18, 1929, reversing a decision of the United States Board of Tax Appeals. (R. 37.)

STATEMENT

In 1912 the Atlantic Dredging Company entered into a contract with the United States Government to dredge a part of the Delaware River, and the respondent, as agent for the Atlantic Dredging Com-

pany, was engaged in carrying on the work under said contract during the years 1913, 1914, and 1915. Having operated at a loss under the contract, the respondent, in December, 1915, refused to proceed with the work. In 1916 it brought suit in the Court of Claims against the United States to recover the sum of $545,121.72 on the ground that the United States has failed to make a proper disclosure in its specification of the character of the material to be dredged. The suit was brought in the name of "Atlantic Dredging Company, W. E. Brooks, Agent." (R. 12.)

On June 3, 1918, the Court of Claims decided that the Atlantic Dredging Company was entitled to recover the sum of $211,050.09, and entered a judgment in that amount. *Atlantic Dredging Co.* v. *United States*, 53 C. Cls. 490. (See also R. 13.)

This Court affirmed the judgment on April 26, 1920. *United States* v. *Atlantic Dredging Co.*, 253 U. S. 1. (See also R. 13.)

The amount of the judgment, $211,050.09, together with interest in the sum of $16,305.71, or a total of $227,355.80, was paid in 1920. (R. 13.)

Of the amount recovered, the Atlantic Dredging Company received $34,778.21 and the respondent $192,577.59. This latter sum included interest in the amount of $16,305.71, leaving a balance of $176,271.88, which respondent received for the work which it had performed. (R. 13.)

The actual expenditures of respondent in carrying out the contract amounted to $354,009.19. The

amount paid respondent by the Government, under the contract and the supplemental contract subsequently entered into, was $142,959.10. The difference, $211,050.09, was recovered under the judgment. (R. 13.)

The principal sum received by respondent under the judgment, $176,271.88, represents the difference between the amounts received by respondent under the contract, during each of the years 1913, 1914, 1915, and 1916, and the amounts expended by respondent in performing the work during each of those years. (R. 13.) These expenditures were reported in the respondent's returns for the years in question. The returns showed losses for 1913, 1915, and 1916 and net income for 1914. (R. 14.)

Prior to 1920 the United States denied all liability to respondent for any sum in addition to that due under the contract and paid. Furthermore, respondent did not carry on its books, as an asset, any sum relating to its claim against the Government until payment of the judgment was had, in 1920. (R. 13.)

Respondent did not include in its return for 1920 the amount of the judgment recovered against the United States. (R. 14.)

The Commissioner of Internal Revenue, in reviewing the respondent's return, determined that the entire amount paid pursuant to the judgment was income for 1920 and as a result asserted a deficiency in tax of $50,883.90. (R. 12.) The respondent took an appeal to the Board of Tax

Appeals, which rendered its decision April 10, 1928, upholding the determination of the Commissioner. (R. 21–22.) From this decision of the Board of Tax Appeals, the respondent, on October 4, 1928, appealed to the Circuit Court of Appeals for the Fourth Circuit (R. 22), which, on October 18, 1929, reversed the decision of the Board of Tax Appeals, holding that the amount collected under the judgment in question constituted reimbursement of losses sustained under the contract, and as such was not taxable income. It remanded the case with directions that upon the filing of amended returns for 1913 to 1916, eliminating the deductions claimed on account of the loss which had been reimbursed, the amount received in reimbursement should be eliminated from the computation of taxable income for the year 1920. One judge dissented. (R. 30–36).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred—

I. In holding that the amount collected in 1920 under the judgment against the United States should be excluded from the taxpayer's gross income for that year.

II. In considering and deciding questions directly affecting tax liability for the taxable years 1913 to 1916, when such taxable years were not involved in the taxpayer's petition to the Board of Tax Appeals.

III. In holding that by virtue of the collection of a judgment against the United States in 1920 the

taxpayer's returns for 1913 to 1916, inclusive, may properly be amended by eliminating therefrom the deductions claimed for expenditures under its contract with the Government to the extent that such deductions exceed the amounts received under the contract.

REASONS FOR GRANTING THE WRIT

The Circuit Court of Appeals in deciding the instant case has apparently laid down the principle that the term "gross income" as used in the revenue laws relates only to profits and that where a transaction does not result in a profit any amount received at the termination of the transaction represents a recoupment of the expenses incurred and does not represent gross income. This principle finds no support in the statute.

The Circuit Court of Appeals has further held in effect that where expenditures were incurred on a contract during the years 1913 to 1916, and compensation for work performed (in addition to that paid under the contract), or damages compensatory of the additional cost of the work, were recovered in 1920 by means of a judgment, the latter sum did not constitute gross income for the year in which the judgment was rendered and collected.

It does not appear from the record whether the taxpayer's income for 1920 was reported on the cash basis or on the accrual basis. Accordingly, if the Commissioner's action in determining that the amount of the judgment constituted taxable income

for the year 1920 could have been sustained under either assumption, his determination of the deficiency, which determination was *prima facie* correct, should have been approved. *Wickwire* v. *Reinecke,* 275 U. S. 101; *United States* v. *Rindskopf,* 105 U. S. 418.

The Commissioner's action in treating the amount of the judgment as taxable income for the year 1920 is fully justified, if the taxpayer was on a cash receipts and disbursements basis, and the record does not establish that it was not. It is well settled that compensation for services rendered or work done must be reported as gross income for the year in which received regardless of the year or years in which it was performed. *Edwards* v. *Keith* (C. C. A. 2d), 231 Fed. 110; *Woods* v. *Lewellyn* (C. C. A. 3d), 252 Fed. 106; *Jackson* v. *Smietanka* (C. C. A. 7th), 272 Fed. 970. If, therefore, the amount of the judgment be regarded as additional compensation for the work performed, as it was by the Board, the same rule should apply here. Nor is the rule different if the judgment in fact represented damages measured by the additional cost of performing the work due to the misrepresentation of the Government.

The Circuit Court of Appeals, however, directed that the case be remanded with instructions that the amount of the judgment be eliminated from taxable income for the year 1920 upon the filing of amended returns for the years 1913 to 1916, "eliminating the deductions claimed on account of the loss which has

been reimbursed," that is, eliminating deductions for expenditures on the contract to the extent that they exceeded the compensation reported under it. None of the years in question were involved in the taxpayer's appeal to the United States Board of Tax Appeals from the Commissioner's determination or in the Board's order of redetermination. The case, therefore, raises an important question as to the extent to which the Circuit Court of Appeals, in reviewing a decision of the Board involving one year, may consider and decide questions affecting other years.

Moreover, this decision of the Circuit Court of Appeals as to 1913, 1914, 1915, and 1916 can only be justified on the theory that the amount of the judgment constituted income accrued during those years. But there was no statutory provision for returns on the accrual basis prior to 1916 and there is no finding that this taxpayer was on the accrual basis in any of those years. The decision is thus in conflict with *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, where it was held that under the Revenue Act of 1913 gross income should be reported for the year in which received.

The decision of the Circuit Court of Appeals has thus raised a doubt with respect to important questions of Federal tax law which it was thought had previously been settled otherwise and as to others which have not been, but should be, authoritatively decided by this Court.

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Wherefore, it is respectfully submitted that the petition should be granted.

CHARLES E. HUGHES, Jr.,
Solicitor General.

JANUARY, 1930.

BRIEF IN SUPPORT OF THE PETITION

OPINIONS BELOW

The opinion of the United States Circuit Court of Appeals (R. 30–36) is reported in 35 F. (2d) 312. The opinion of the United States Board of Tax Appeals (R. 11–21) is reported in 11 B. T. A. 452.

JURISDICTION

The judgment of the United States Circuit Court of Appeals was entered October 18, 1929. (R. 37.) The jurisdiction of this Court rests on the provisions of Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

In 1920 the taxpayer recovered and collected a judgment against the United States for a sum equal to the amount by which expenditures made during the years 1913 to 1916 in performance of a contract exceeded the compensation received under it in those years. The questions are:

1. Should the amount of the judgment be included in the taxpayer's gross income for the purpose of determining its income-tax liability for the year 1920?

2. Did the Circuit Court of Appeals have authority to consider and decide questions directly affect-

ing tax liability for the years 1913 to 1916, inclusive, when such taxable years were not involved in the taxpayer's petition to the Board of Tax Appeals?

3. Should the income-tax liability of the taxpayer for the years 1913 to 1916, inclusive, be redetermined by eliminating the deductions for expenditures made under the contract to the extent that they exceeded compensation received under the contract during those years?

STATUTES INVOLVED

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1064–1065, 1077:

> SEC. 212. (b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. * * *
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> * * * * * *
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> SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—
>
> (a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or

from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period * * *.

SEC. 233. (a) That in the case of a corporation subject to the tax imposed by section 230 the term "gross income" means the gross income as defined in section 213 * * *.

Revenue Act of 1926, c. 27, 44 Stat. 9, 55, 63, 110:

SEC. 274. (a) If in the case of any taxpayer, the Commissioner determines that there is a deficiency in respect of the tax imposed by this title, the Commissioner is authorized to send notice of such deficiency to the taxpayer by registered mail. Within 60 days after such notice is mailed (not counting Sunday as the sixtieth day), the taxpayer may file a petition with the Board of Tax Appeals for a redetermination of the deficiency. Except as otherwise provided in subdivision (d) or (f) of this section or in section 279,

282, or 1001, no assessment of a deficiency in respect of the tax imposed by this title and no distraint or proceeding in court for its collection shall be made, begun, or prosecuted until such notice has been mailed to the taxpayer, nor until the expiration of such 60-day period, nor, if a petition has been filed with the Board, until the decision of the Board has become final. * * *

(b) If the taxpayer files a petition with the Board, the entire amount redetermined as the deficiency by the decision of the Board which has become final shall be assessed and shall be paid upon notice and demand from the collector. No part of the amount determined as a deficiency by the Commissioner but disallowed as such by the decision of the Board which has become final shall be assessed or be collected by distraint or by proceeding in court with or without assessment.

* * * * *

(g) The Board in redeterminating a deficiency in respect of any taxable year shall consider such facts with relation to the taxes for other taxable years as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other taxable year has been overpaid or underpaid.

SEC. 283. (a) If after the enactment of this Act the Commissioner determines that any assessment should be made in respect of any income, war-profits, or excess-profits tax imposed by * * * the Revenue

Act of 1918, * * * or by any such Act as amended, the Commissioner is authorized to send by registered mail to the person liable for such tax notice of the amount proposed to be assessed, which notice shall, for the purposes of this Act, be considered a notice under subdivision (a) of section 274 of this Act. In the case of any such determination the amount which should be assessed (whether as deficiency or as interest, penalty, or other addition to the tax) shall, except as provided in subdivision (d) of this section, be computed as if this Act had not been enacted, but the amount so computed shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations * * * as in the case of a deficiency in the tax imposed by this title, except as otherwise provided in section 277 of this Act.

(b) If before the enactment of this Act any person has appealed to the Board of Tax Appeals under subdivision (a) of section 274 of the Revenue Act of 1924 (if such appeal relates to a tax imposed by Title II of such Act or to so much of an income, war-profits, or excess-profits tax imposed by any of the prior Acts enumerated in subdivision (a) of this section as was not assessed before June 3, 1924), and the appeal is pending before the Board at the time of the enactment of this Act, the Board shall have jurisdiction of the appeal. In all such cases the powers, duties, rights, and privileges of the Commissioner and of the person who has brought the

appeal, and the jurisdiction of the Board and of the courts, shall be determined, and the computation of the tax shall be made, in the same manner as provided in subdivision (a) of this section, except as provided in subdivision (j) of this section and except that the person liable for the tax shall not be subject to the provisions of subdivision (d) of section 284.

SEC. 1003. (a) The Circuit Courts of Appeals and the Court of Appeals of the District of Columbia shall have exclusive jurisdiction to review the decisions of the Board (except as provided in section 239 of the Judicial Code, as amended); and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 240 of the Judicial Code, as amended.

(b) Upon such review, such courts shall have power to affirm or, if the decision of the Board is not in accordance with law, to modify or to reverse the decision of the Board, with or without remanding the case for a rehearing, as justice may require.

STATEMENT

A statement of the facts and of the errors relied on will be found in the petition.

ARGUMENT

The Circuit Court of Appeals in deciding the instant case has apparently laid down the principle that the term "gross income" as used in the revenue

laws relates only to profits and that where a transaction does not result in a profit any amount received at the termination of the transaction represents a recoupment of the expenses incurred and does not represent gross income.

The principle finds no support in the statute. Under the definition of gross income in Section 213 (a) of the Revenue Act of 1918, *supra*, a profit *may* constitute gross income, as for example where there are no expenditures in connection with the transaction, and the entire amount received constitutes a profit. The definition of gross income in that section, however, includes "gains or profits and *income* derived from any source whatever." If by the profit on a transaction is meant the excess of payments received over expenditures made, then to consider the term "gross income" as synonymous with "profits" as applied to corporate taxpayers would be to destroy the effect of other provisions of the statute which require such taxpayers to report in their return the allowable deductions from and credits against gross income, the tax being computed on the net amount remaining.

It follows that the question as to whether the sum of $176,271.88 received by this taxpayer pursuant to the judgment of the Court of Claims as affirmed by this Court constitutes gross income can not be decided by determining whether not any, or all, or only a part, of the judgment in question represented a profit. On the contrary, the decision is

necessarily controlled by the nature and purpose of the payment.

The record discloses that the taxpayer decided not to proceed under its contract with the Government for dredging the Delaware River and brought suit against the Government because of conditions which proved to be contrary to representations, and that prior to the abandonment of the work it had during 1913 to 1916 received from the Government on the basis of the unit prices set out in the original contract and a supplemental contract the sum of $142,959.10. (R. 12, 13.) In its finding of facts the Board of Tax Appeals stated that the amount of the judgment was paid to the taxpayer for work performed. (R. 13.) See also *Atlantic Dredging Co* v. *United States*, 53 C. Cls. 490, 253 U. S. 1. While, in view of the nature of the action which was brought and in view of the language of this Court's decision, it is probably more accurate to designate the amount of the judgment as damages compensatory of the added cost of the work performed, the same principles would apply in either case. Accordingly, for the purpose of this petition, the judgment will be referred to as compensation for work performed in accordance with the Board's findings of fact.

It is not readily perceived why the amount paid under the judgment as the result of this Court's decision is of a different character from the amounts received on the unit basis under the express con-

tract. Both were in the nature of compensation for work performed. The fact that the amount of the judgment did not show a profit to the respondent over the cost of doing the work does not change its character as gross income. In the case of any contract the expenditures may exactly equal the compensation received under such contract but the taxpayer in such case is not allowed to exclude the compensation from gross income. As stated by Circuit Judge Northcott in his dissenting opinion, the respondent's business was carried on in an effort to make a profit, and the fact that no profit resulted does not change the character of the money received. (R. 36.)

The case of *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170, relied upon by the Circuit Court of Appeals, is distinguishable on the facts. In the instant case there was a transaction arising out of the operation of a business where compensation was collected for work performed in earlier years, the expenditures made in performing the work having been properly deducted in those years. In the *Kerbaugh-Empire Co. case* the whole transaction was a capital transaction. There the taxpayer borrowed money, giving a note payable in German marks, and there was a loss of the money borrowed; later the taxpayer settled the debt for a smaller amount in American currency, due to the decline in the rate of exchange.

The Circuit Court of Appeals' decision, moreover, in effect treated the amount of the judgment as income (though not for 1920), for it directed that when the taxpayer should file amended returns for the years 1913 to 1916, inclusive, eliminating the deductions for expenditures made in performing the contract to the extent that they exceeded the amounts received under it, the amount of the judgment should be eliminated from taxable income for the year 1920.

The record in this case does not show whether the taxpayer filed its return for 1920 on a cash receipts and disbursements basis or on an accrual basis. In a suit to recover a tax the determination of the Commissioner is prima *facie correct*, *Wickwire* v. *Reinecke*, 275 U. S. 101; *United States* v. *Rindskopf*, 105 U. S. 418, and the burden is on the taxpayer to establish the incorrectness of the Commissioner's determination. *Botany Mills* v. *United States*, 278 U. S. 282. The rule is the same in an appeal to the Board. *Avery* v. *Commissioner of Internal Revenue* (C. C. A. 5th), 22 F. (2d) 6. In view of this rule and the state of the record the Commissioner's determination was properly approved by the Board, if the Commissioner's action was justified either on the assumption that the taxpayer was on a cash basis or on the assumption that it was on the accrual basis. Since either assumption would justify the tax, the Circuit Court of Appeals erred in reversing the decision of the Board.

In the case of a taxpayer on the cash receipts and disbursements basis, Section 213 (a) of the Revenue Act of 1918, *supra*, requires that the items of gross income shall be reported for the year in which received. Moreover, it is well settled that compensation for services rendered or work done must be reported as gross income for the year in which received, regardless of the year in which the work was performed. *Edwards* v. *Keith* (C. C. A. 2d), 231 Fed. 110; *Woods* v. *Lewellyn* (C. C. A. 3d), 252 Fed. 106; *Jackson* v. *Smietanka* (C. C. A. 7th), 272 Fed. 970.

In the instant case the work was done in the years 1913 to 1916, but no portion of the compensation paid under the judgment was received until 1920. Obviously, it constituted gross income for 1920, if the taxpayer was on a cash basis. The regulations relating to long-term contracts which are quoted in the opinion of the Circuit Court of Appeals might have given this taxpayer the option of reporting all of the income received from the transaction on a different basis if it had availed itself of the privilege, but it did not elect to report it on that basis.

The Circuit Court of Appeals, however, directed that the case be remanded with instructions that the amount of the judgment be eliminated from taxable income for the year 1920 upon the filing of amended returns for the years 1913 to 1916, "eliminating the deductions claimed on account of the

loss which has been reimbursed"; that is, eliminating deductions for expenditures on the contract to the extent that they exceeded the compensation reported under it.

It is our position that the Circuit Court of Appeals had no authority to consider and determine any question directly affecting tax liability for the years 1913 to 1916. Upon an appeal from the Board of Tax Appeals, the jurisdiction of the Circuit Court of Appeals is limited to a review of the decision of the Board on errors of law.

In the instant case the Board entered no order of redetermination as to the years 1913 to 1916, and it had no power to do so, for no deficiencies had been determined for those years and the taxpayer's petition involved only the year 1920. While under Section 274 (g) of the Revenue Act of 1926, *supra*, the Board had authority to determine such facts for other years as were required for a correct determination of the taxpayer's liability for 1920, it was prohibited under that section from finding an overpayment or underpayment for those other years. *Wolf Mfg. Co.* v. *Commissioner of Internal Revenue,* 10 B. T. A. 1161; *D. L. Blackstone, Administrator* v. *Commissioner of Internal Revenue,* 12 B. T. A. 456.

If, however, we are in error as to the question of the jurisdiction of the Circuit Court of Appeals over the years 1913 to 1916, it is our position that that court's adjustment for those years could only

be justified on the theory that the amount of the judgment was then accrued. The loss on the contract which the returns for those years disclosed arose by virtue of the fact that the expenses incurred in connection with it exceeded the income. If, therefore, these so-called losses, which are in reality only an excess of expenditures over income, are to be eliminated, it can only be on the theory that there is additional income to apply against them. The amount of the judgment was obviously not income actually received until 1920. It follows, therefore, that if it is to be applied against the expenditures incurred during 1913 to 1916, as it has been under the Circuit Court of Appeals' decision, it must be treated as accrued income for those years. But the Revenue Acts contained no provision for returns on the accrual basis prior to 1916 and there is nothing in the record to show that this taxpayer was on that basis in any of the years in question.

If this be the correct view of the situation, and we believe that it is, the decision is contrary in principle to that of *Maryland Casualty Co.* v. *United States,* 251 U. S. 342, where it was recognized that under the Revenue Act of 1913 gross income is to be reported when received. That decision necessarily controls the years 1913, 1914, and 1915.

CONCLUSION

We submit that the decision of the Circuit Court of Appeals was erroneous, and, in view of the general importance of the questions decided in the

administration of the tax laws, that the petition for certiorari should be granted.

CHARLES E. HUGHES, JR.,
Solicitor General.

G. A. YOUNGQUIST,
Assistant Attorney General.

J. LOUIS MONARCH,

HELEN R. CARLOSS,
Special Assistants to the Attorney General.

C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

PREW SAVOY,
Special Attorney,
Bureau of Internal Revenue.

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